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No. 85-1405

In the Supreme Court of the United States

OCTOBER TERM, 1985

RODERICK J. MACKENZIE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioners lacked the intent to violate the tax laws because of uncertainties in the legal standards for classifying workers as employees or independent contractors.

2. Whether Section 530 of the Revenue Act of 1978 protects petitioners from criminal prosecution for failing to withhold taxes from their workers' wages.

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OPINION BELOW

The opinion of the court of appeals (Pet. App. 1a-24a) is reported at 777 F.2d 811.

JURISDICTION

The judgment of the court of appeals was entered on November 20, 1985. A petition for rehearing was denied on January 21, 1986 (Pet. App. 25a). The petition for a writ of certiorari was filed on February 21, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the District of Connecticut, petitioners David H. MacKenzie, Inc., Roderick J. MacKenzie and Malcolm MacKenzie were convicted of conspiracy to defraud the United States under 18 U.S.C. 371; Roderick MacKenzie

was convicted on eleven counts of making and subscribing false employer's quarterly tax returns under 26 U.S.C. 7206(1); and Roderick and Malcolm MacKenzie were convicted under 26 U.S.C. 7206(2) on five counts of aiding and assisting the filing of false employee's tax returns. David H. MacKenzie, Inc., was sentenced to a $10,000 fine. Roderick MacKenzie was sentenced to a $10,000 fine, three years' imprisonment with all but 30 days suspended on the conspiracy count, and one year's probation on each of the other counts, all to run concurrently. Malcolm MacKenzie was sentenced to three years' imprisonment with all but six months suspended, and two years' probation on each count, all to run concurrently. Pet. App. 3a-4a.

1. During the period at issue, petitioner Roderick MacKenzie was president, and petitioner Malcolm MacKenzie, his son, was general manager of petitioner David H. MacKenzie, Inc. That company is a family painting business that employs full-time painters pursuant to a union contract with the Painters and Allied Trades Union (Tr. 94-97, 6455).[1] Beginning around 1970, the company contracted to have the Citytrust Bank of Bridgeport, Connecticut, prepare its computerized payroll checks. The bank arranged to hold the company's withholding taxes and prepare W-2 forms for its individual employees. The company calculated the employees' wages by applying the union wage rates to the hours reported on the employees' daily timesheets. That information was then forwarded to Citytrust Bank for preparation of the payroll. Tr. 104-111, 1581-1583.

In 1975, the company began to use a system of paying workers for some work without withholding taxes. Those payments were made by checks separate from the payroll

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[1]Trial transcript references are taken from the government's brief in the court of appeals.

checks prepared by the bank. Tr. 139-142. The company first used this system to pay two union employees for work they did on a piecework basis rather than by the hour. The two employees accepted payment on this basis at the request of petitioners Roderick and Malcolm MacKenzie. Tr. 3091-3093, 3098-3102. The company next used the same system in paying several workers, including petitioner Malcolm MacKenzie and his brother, David MacKenzie, for their work on weekend painting jobs at less than the union scale (Tr. 3110-3116).

In July 1976, the use of the non-withholding system spread to a majority of the union employees. Petitioner Roderick MacKenzie and James Auger, the shop superintendent, informed the employees that overtime would thereafter be paid at less than the time and one-half rate required by the union and that the employers would be paid by separate checks with no taxes withheld. The employees agreed to the plan; the amount of the separate checks, without withholding, approximately equaled the net amount the employees would have received under the union rate after withholding. Tr. 2056, 2328, 2373.

The company also used separate checks—with no reduction for withholding—for holiday pay of union workers, for bonuses for salaried employees and for pay to employees who worked during a strike (Pet. App. 4a; Tr. 678-680, 743-750). Moreover, in several instances workers requested and received permission to be paid "off the books" for their regular working hours (Pet. App. 11a). In 1979, the company began to pay these amounts either directly in cash or by checks made payable to cash (Pet. App. 12a).

From 1976 through 1979, the company made virtually all overtime, bonus, and holiday payments "off the books," maintaining records of those payments on payroll registers kept separately from the registers that were sent to Citytrust

Bank (Tr. 155-156). Those payments were not reported to the Internal Revenue Service (Pet. App. 4a). Initially, the payments were recorded in a "materials purchased" account. After April 1978, when the company's accountant became suspicious of the increasing size of that account, the payments were recorded in a "labor purchased" account (Tr. 803, 4981; Pet. App. 4a). When the accountant questioned petitioner Roderick MacKenzie and the company's bookkeeper, he was told that the company was using more independent contractors. He was not told that regular employees were involved, and he was not shown the separate payroll sheets (Tr. 5684-5688, 5723-5728).

In 1977, petitioners established a division of the company to do painting jobs with non-union employees at fixed hourly rates. The non-union workers were supervised by Dennis McDevitt, who had previously worked as an outside contractor for the parent corporation. Petitioner Malcolm MacKenzie directed McDevitt to hire workers and made decisions concerning raises for the non-union workers. When contacted concerning loan applications, the MacKenzies verified that McDevitt and some of his men were employees of the parent company. Originally, McDevitt received a payroll check from the company for the wages of the non-union workers and paid the non-union workers in cash. The wages paid to the non-union workers were not reported to the Internal Revenue Service, nor were income or social security taxes withheld. In 1979, after the company had come under investigation by the Internal Revenue Service, the company notified the non-union employees that they could choose to go on the regular payroll. At the same time, the company also prepared copies of Form 1099, the document that must be filed if an independent contractor is paid $600 or more, for those workers who chose not to be paid from the regular payroll. Pet. App. 5a, 12a.

2. The court of appeals affirmed petitioners' convictions. (Pet. App. 1a-12a). It rejected petitioners' contention that their convictions were invalid because of uncertainty in the law concerning the status of workers as employees or independent contractors. The court found that there was not "any doubt—much less a reasonable one" that the workers involved in this case were not independent contractors, but were employees of the company, as to whom petitioners had a duty to withhold income and social security taxes (Pet. App. 11a). The court concluded that petitioners had failed to state any "plausible claim that, as applied to them, the statute and regulations [distinguishing between employees and independent contractors] were impermissibly vague" (Pet. App. 13a). In addition, the court found that petitioners' conduct revealed a "subjective belief in the unlawfulness of the conduct" (Pet. App. 16a).

The court also rejected petitioners' contention that criminal penalties were barred by Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2885-2886, a provision that protected employers from civil liability for treating workers as independent contractors, when that treatment was consistent and had a reasonable basis. The court found that Congress "could hardly have intended to abate criminal prosecutions where there is not only a lack of good faith but also deliberate tax evasion with concealed records and with intent to defraud" (Pet. App. 14a).

ARGUMENT

The decision of the court of appeals is plainly correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Petitioners first contend (Pet. 11-17) that they lacked the requisite intent to violate the tax laws. Because the status of some of the company's workers presented novel

and uncertain questions of tax law, petitioners argue, they cannot be prosecuted for their failure to treat the workers as employees for the purposes of income tax and social security tax withholding. The court of appeals correctly rejected this contention.

In general, the status of a worker is to be determined in accordance with the common law definition of an employee. See Section 3121(d)(2) of the Internal Revenue Code of 1954 (26 U.S.C.). The critical test is whether the person for whom services are performed "has the right to control and direct the individual who performs the services" (Treasury Regulations on Employment Tax, 26 C.F.R. 31.3401(c)-1(b)).

This standard is sufficiently certain to support petitioners' convictions. It is well established that vagueness challenges to statutes that do not involve First Amendment freedoms must be examined in light of the facts of the case at hand. *United States* v. *Mazurie*, 419 U.S. 544, 551 (1975); *United States* v. *National Dairy Products Corp.*, 372 U.S. 29 (1963). Thus, a defendant's challenge to the tax laws must be specific rather than facial. Moreover, the defendant cannot rely on hypothetical situations to demonstrate uncertainty in the law. *United States* v. *Irwin*, 354 F.2d 192, 196 (2d Cir. 1965), cert. denied, 383 U.S. 967 (1966). As the court of appeals noted (Pet. App. 12a-13a): "That the statute and regulations may present some doubtful cases does not mean that they are void for vagueness."

As applied to the facts of this case, the standards for determining the existence of an employer-employee relationship provided ample guidance. As the court of appeals noted (Pet. App. 11a), it is clear that the union painters who were paid, without withholding, for overtime and holiday work were employees, since they were paid as employees for their regular working hours. Nothing in the record remotely

suggests that, during the times the workers were being paid "off the books," their working arrangement—particularly the nature of the control exercised over them—was different from when they were on the regular payroll. Plainly, the purpose of petitioners' scheme was simply to enable the company to save labor costs at the government's expense.

The status of the non-union employees was also clear-cut. Petitioner Malcolm MacKenzie directed McDevitt to hire specific workers and decided on pay raises for workers. Petitioners Malcolm and Roderick MacKenzie both told financial institutions that McDevitt and some of his men were employees of the corporation. Moreover, petitioners' failure to file the required 1099 forms was inconsistent with a good faith belief that the workers were independent contractors.

The absence of any uncertainty in the law as applied to petitioners' workers distinguishes this case from the cases on which petitioners rely: *James* v. *United States,* 366 U.S. 213 (1961); *United States* v. *Mallas,* 762 F.2d 361 (4th Cir. 1985); *United States* v. *Dahlstrom,* 713 F.2d 1423 (9th Cir. 1983), cert. denied, 466 U.S. 980 (1984); *United States* v. *Garber,* 607 F.2d 92 (5th Cir. 1979); and *United States* v. *Critzer,* 498 F.2d 1160 (4th Cir. 1974). But even if the law as applied had been open to good faith differences of opinion, petitioners would not be entitled to have their convictions set aside. In *James,* from which the foregoing court of appeals decisions stem, this Court did not hold that uncertainty in the law negates willfulness as a matter of law.[2] And

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[2]In *James,* the defendant was convicted of attempted income tax evasion for failing to report embezzled funds. This Court held such funds taxable, overruling a prior decision, *Commissioner* v. *Wilcox,* 327 U.S. 404 (1946), in which it had held to the contrary. Despite the holding as to the taxability of embezzled funds in *James,* this Court reversed the conviction. In a plurality opinion (366 U.S. at 221-222), three Justices concluded that willfulness could not be proved so long as

this Court has never so held. Indeed, such a holding would conflict with the settled principle that the element of willfulness "relieve[s] the statute of the objection that it punishes without warning an offense of which the accused was unaware." *Screws* v. *United States*, 325 U.S. 91, 102 (1945); see *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 342 (1952); *United States* v. *Ragen*, 314 U.S. 513, 524 (1942); *Gorin* v. *United States*, 312 U.S. 19, 26-28 (1941); *Hygrade Provision Co.* v. *Sherman*, 266 U.S. 497, 502-503 (1925).

In this case, there was abundant evidence of willfulness: petitioners clearly knew that their workers should be classified as employees, and they acted in bad faith in failing to withhold taxes. The company kept its payments in question on a separate set of books, it concealed the nature of the

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the tax statute contained the gloss placed on it by *Wilcox*, even though the vitality of *Wilcox* had been undermined earlier by *Rutkin* v. *United States*, 343 U.S. 130 (1952). The three dissenting Justices concluded that the element of willfulness depended on whether the defendant had actually relied on *Wilcox* (366 U.S. at 241, 242-243). The three concurring Justices, who dissented on the question of overruling *Wilcox*, necessarily agreed with the plurality that the conviction should be reversed, but two of them—Justices Black and Douglas—criticized the plurality's decision to make its holding prospective only and stated that, if *Wilcox* was correctly overruled, the defendant was guilty of violating the tax evasion statute (366 U.S. at 223-225). Thus, a majority of the Court did not subscribe to the conclusion that the uncertainty in the law negated willfulness as a matter of law. Moreover, this Court subsequently characterized *James* as holding merely that "[t]he requirement of an offense committed 'willfully' is not met * * * if a taxpayer *has relied in good faith* on a prior decision of this Court." *United States* v. *Bishop*, 412 U.S 346, 361 (1973) (emphasis added). Similarly, the Second and Sixth Circuits have held that uncertainty in the law does not negate willfulness where there was no connection between the uncertainty and the defendant's state of mind. *United States* v. *Ingredient Technology Corp.*, 698 F.2d 88 (2d Cir.), cert. denied, 462 U.S. 1131 (1983); *United States* v. *Curtis*, No. 85-5070 (6th Cir. Jan. 28, 1986) (Pet. App. 117a).

payments from the company's accountant, and in 1979 it began to pay workers in cash or by checks made out to cash. Pet. App. 11a.

2. Petitioners also contend that the courts below erred in holding that Section 530 of the Revenue Act of 1978 (92 Stat. 2885-2886), has no application to this case. This contention lacks merit.

Section 530 provides that if, prior to 1980, "the taxpayer did not treat an individual as an employee for any period" and all federal tax returns required to be filed after December 31, 1978, with respect to such individual "are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee," then for the purposes of applying withholding taxes "the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee." The statute was adopted to protect taxpayers who, having reasonably believed workers not to be employees, faced large assessments and penalties as a result of reclassification of their workers by the Internal Revenue Service. See H.R. Conf. Rep. 95-1800, 95th Cong., 2d Sess. 271 (1978); *Ridgewell's, Inc.* v. *United States,* 655 F.2d 1098, 1101 (Ct. Cl. 1981).

Nothing in the language or legislative history of Section 530 suggests that the statute was intended to preclude criminal prosecutions for willful violations of the withholding laws. Indeed, because it excepts employers who "had no reasonable basis" for their actions, Section 530 by its own terms does not protect the taxpayer who willfully fails to withhold taxes from the pay of an employee. A willful violation is " 'a voluntary, intentional violation of a known legal duty.' " *United States* v. *Pomponio,* 429 U.S. 10, 12 (1976). The willfulness standard is designed to separate the purposeful violator from the "well-meaning, but easily

confused, mass of taxpayers" (*United States* v. *Bishop*, 412 U.S. 346, 361 (1973)) and to avoid penalizing innocent errors made despite the exercise of reasonable care, *Spies* v. *United States*, 317 U.S. 492, 497 (1943). Thus, a taxpayer who willfully violates his duty to treat a worker as an employee and to withhold taxes from the worker's pay necessarily has no reasonable basis for his conduct. Petitioners' contention (Pet. 23-24) that Section 530 bars application of criminal penalties whenever a taxpayer's conduct is objectively reasonable, regardless of his good faith, is thus inconsistent with the plain language of Section 530.[3] Application of the statute does not depend on whether the taxpayer's classification of the worker was reasonable in the abstract.

The legislative history of Section 530 confirms that Congress did not intend to protect taxpayers who intentionally or willfully disobeyed their statutory duties. The Senate Report (S. Rep. 95-1263, 95th Cong., 2d Sess. 211 (1978)) specifically states:

> [A] taxpayer will not be considered to have acted in good faith if his treatment of individuals as independent contractors would, on the basis of the pertinent facts and circumstances, constitute negligence, intentional disregard of rules and regulations, or fraud within the meaning of section 6653 of the Code.

There is no merit to petitioners' claim (Pet. 23) that this comment relates only to the "good faith" standard that was used in the original Senate version of Section 530, not to the

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[3]The need for actual good faith reliance, rather than simply objective reasonableness, is further demonstrated by Section 530(a)(2), 92 Stat. 2885-2886, which provides that a taxpayer will be treated as having a reasonable basis for not treating a worker as an employee if the taxpayer acted "in reasonable reliance" on (a) judicial precedent or rulings, (b) a past Internal Revenue Service audit, or (c) long-standing industry practice.

"reasonable basis" standard that was ultimately enacted. The conference committee report (H.R. Conf. Rep. 95-1800, 95th Cong., 2d Sess. 271 (1978)), explains that the final bill is substantially the same as the Senate Bill, and that the final version followed the text of the House Bill for "technical reasons."[4] Indeed, the substantial identity between the standards used in the two versions is demonstrated by the fact that the "good faith" requirement in the Senate Bill would be satisfied by the same factors that establish "reasonableness" under the final version of the statute: the taxpayer's reliance on past audit practice, his reliance on legal precedent or rulings, or his reliance on a recognized industry practice. See Pet. App. 43a-45a.[5]

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[4]Petitioners incorrectly contend (Pet. 23 n.13) that *Ridgewell's, Inc.* v. *United States*, 655 F.2d 1098, 1104 (Ct. Cl. 1981), supports their contention that the legislative history of the Senate Bill is irrelevant. In contrast to the mere change in language used to describe the standard involved in this case, *Ridgewell's* dealt with a change in the bill that was specifically designed to limit the requirement of treating employees consistently to returns filed after December 31, 1978. See Pet. App. 26a-27a.

[5]Even under the standard proposed by petitioners, their conduct was *not* objectively reasonable. Petitioner Malcolm MacKenzie's testimony reveals that the classification of workers as employees or independent contractors was entirely arbitrary: he testified that the sole basis for the classification was whether taxes were withheld (Tr. 6901-6902). In light of petitioners' control over their workers at all times, there simply was no objectively reasonable basis for classifying the workers as independent contractors.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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